Micro-and SME Finance

The growth and increasing commercialization of microfinance has undoubtedly been one of the most significant global developments in financial services over the past quarter-century. More recently, the expansion of financial services to SMEs has been a major area of focus for donors, not least USAID.

Our rationale for omitting these two important trends from our list stems from the fact that, while critical, micro- and SME finance programs are concerned with extending the reach of financial services in the interest of general economic and private sector development, not with the inherent stability or performance of financial sectors per se.

II.B.2 Globalization, Consolidation, and Governance of Intermediaries and Markets

Globalization and Systemic Risk

Globalization of financial markets has been, on balance, positive for developing countries. Intermediaries from developed countries have brought new capital, expertise, and credibility to nascent financial systems through inward investment. Governments and top-tier companies have been able to tap global markets to raise capital for investment, strengthen their profile, better manage liquidity, and trade foreign currency in a range of financial centers across the world. Companies list on foreign exchanges, borrow debt through foreign security markets and international banks and conduct their payments through a range of global facilities. As a result, market players are much better informed about the international alternatives to local financial products and are able to assess the value to be had from the domestic financial sector in that light. World Bank data show an enormous rise in cross-border portfolio and direct investment over the last decade. Much of this investment has been directed towards developing countries, although disproportionately towards a small number of relatively promising markets.

However, financial crises have demonstrated the severe risks inherent in heavy reliance on international capital flows as a means of growth, particularly for countries with unbalanced macroeconomies, weak domestic financial intermediaries, poor financial sector regulation and supervision and over-leveraged corporations. As recent experience from Thailand, Russia, Mexico, and Argentina shows, capital movements by both domestic and foreign participants can exacerbate crises and facilitate their spread to other countries.

The depth of the country crises in recent years and the danger of contagion have sparked serious consideration of the need for reform along three dimensions:

1. Reform of the International Financial Architecture (IFA) under which cross-border transactions take place;
2. Reform of domestic financial systems to withstand external shocks and contain systemic risk; and
3. Emphasis on real economic growth over direct investment as a means of development

Our Task 1 Report discussed the IFA in some detail along with the changes to be made by developing countries, international financial institutions, and financial intermediaries in developed countries in order to reduce both the likelihood and severity of crises. IFA reforms deal primarily with safeguarding the conditions for international financial transactions. As such, most trends are focused on strengthening exchange rate regimes, improving macroeconomic policy setting and coordination, strengthening payment systems, enhancing transparency, and other broad-based initiatives.

Trends that are more relevant to the donor community are those that pertain specifically to strengthening national financial system stability and initiatives that support real economic growth. Important developments are being seen in the following areas:

Cross-Border Insolvency Reform: In response to the failure of Barings in 1995, international organizations and investor groups have started to examine cross-border insolvencies more carefully, with a view towards understanding and reducing risk exposure to global financial institutions and the potential systemic risks[9]. There has been growing concern by policymakers, multilateral lending agencies, and some global financial institutions that many economies remain unprepared to deal with the cross-border dimensions of insolvency. Development work has focused on areas such as the following: strengthening insolvency and debtor-creditor regimes; develop innovative debt contracts; promotion of creditor cooperation; enhancing mechanisms for orderly workouts; and encouraging better risk management by the private sector.

While many developing countries are challenged by the prospect of developing an effective domestic insolvency system, developments on a global scale underscore the need to look beyond conventional mechanisms and consider the cross-border implications of business failures. Recent experience in Asia, Latin America, and Eastern Europe suggests that the risks associated with weak contract enforceability, ineffective netting, clearing and settlement obstacles, imperfect collateral and security interests, and conflicts of law on a national level in effect weaken the global infrastructure for insolvency.

International Insolvency Regime for Sovereigns: Anne Krueger, Deputy Managing Director of the IMF, recently proposed the introduction of a system akin to domestic bankruptcy procedures for developing countries experiencing financial crisis. It would allow a country, with the consent of the IMF, to impose a temporary standstill on debt repayment while the country negotiated with its creditors. (Whether the IMF or some less conflicted body should consent to a debt payment standstill or other possibly quicker alternatives is still a subject of

[9] *The Group of Thirty has been studying cross-border insolvency. Their work has centered on the direct effect of insolvency on other firms and attempt to identify measures to limit risk after insolvency begins. This project was undertaken in conjunction with INSOL, the international association of lawyers and judges interested in international insolvency.*

debate.) Agreements reached with the large majority of creditors would then be binding on all creditors, preventing small creditors from demanding favorable treatment as recently happened in the case of Peru. The measure proposed is certainly interesting, but controversial; and the prospects for near-term implementation are weak. This idea and variations of it, nevertheless, reflect a move to bring more order to resolving country crises.

Crises Prevention and Contingency Planning: Policymakers and regulators in many countries have undertaken initiatives to prevent and manage contingencies arising from financial crisis. This includes, among other elements: coordination of supervisory policies for the intervention and resolution of troubled institutions; arrangements for the timely application of bankruptcy laws and regulations; guidelines for the treatment of capital market instruments in times of distress; well set out roles and responsibilities of intermediary managers, policymakers, and regulators; as well as a clearly defined set of policies and triggers for lender of last resort intervention. It is also widely recognized that crises prevention requires a clear understanding of non-bank financial intermediaries, the extent of their activities in the economy, and the nature of their financial commitments and risks.

Harmonization of Standards: There is a growing consensus that financial supervision and regulation should be harmonized across national boundaries due to the ever-increasing global interdependence of financial markets. As developing countries grow and prosper, the integration of domestic financial markets with the larger international financial system will become more and more important so that distortions are minimized. Much of the discussion around harmonization has centered on the importance of developing and implementing internationally recognized principles and codes of good practice. International standard-setting bodies, such as those identified

International Standard-Setting Bodies

- *Basel Committee on Bank Supervision:* Accounting task force addressing issues related to transparency, accounting and audit standards in the banking system.
- *International Organization of Securities Commissions (IOSCO):* Drives implementation of standards and codes around market transparency, accounting and auditing and most importantly, enforcement of these standards.
- *IAIS:* Established in 1994, the IAIS seeks to establish international standards on insurance supervision and conducts training seminars for insurance supervisors from emerging markets. The Association also seeks to coordinate its efforts with other global financial regulators, particularly those from the banking and securities industries.
- *Financial Stability Forum (FSF):* Forum of government officials, regulators, financial firms and representatives of the profession whose objective is to enhance international cooperation to promote stability in the financial system. They are instrumental in driving implementation of standards and codes including IAS and ISA.
- *The World Bank/IMF Report on Standards and Codes (ROSC)*: The ROSC process is designed to monitor compliance with standards and codes in a variety of areas including accounting and auditing, corporate governance, transparency in monetary and financial policies, etc.
- *International Forum on Accountancy Development (IFAD):* Formed in 1997 this industry group is focused on improving standards and practices worldwide.
- *International Federation of Accountants (IFAC):* Professional body consisting of 156 national accounting organizations. Sets International Standards on Auditing (ISA).
- *International Accounting Standards Board (IASB):* The International Accounting Standards Board is an independent, privately funded accounting standard setter based in London.

in the text box, are perhaps the most influential in promoting change in developing countries as they seek to harmonize their regulatory environment internationally and "globalize" their financial institutions. From a positive economic perspective, meeting international standards benefits developing countries by increasing the stability of the domestic financial markets and making them more attractive to foreign and domestic investors alike.

The Basle Committee introduced new capital standards and model principles for supervision of banks. The Financial Stability Forum has addressed issues relating to the systemic impact of banks across borders. The World Bank and IMF introduced the FSSAP reviews and have carried out a wealth of comparative studies that form the basis for defining best practices. The organization of International Organization of Securities Commission (IOSCO), Forum of European Securities Commissions (FESCO) and International Association of Insurance Supervisors (IAIS) are international attempts to set global standards for securities and insurance businesses. The European Parliament has been active in setting standards of harmonization for members of the EU, and technical assistance has been provided for accession candidates in Central Europe.

In most of these areas, codes of best practice have been drafted and an attempt is being made to monitor the degree to which countries are implementing best practices. The World Bank and the International Monetary Fund are monitoring twelve areas: data dissemination, fiscal transparency, monetary and financial policy transparency, banking supervision, securities markets supervision, insurance supervision, payments systems, money laundering, corporate governance, accounting, auditing and insolvency regimes and creditors rights[10].

Diminishing Importance of Local Exchanges: There are a number of globalization and technology-related developments affecting developing countries' national stock and commodity exchanges. First, in the face of volatile and shallow domestic markets, blue chip companies in many developing countries increasingly seek listings on developed country share trading systems through Global Deposit Receipts (GDRs) or American Deposit Receipts (ADRs) traded in New York, London and Frankfurt. The movement of securities trading to developed markets is putting liquidity pressure on local exchanges. This issue has received substantial attention in recent conferences and literature (e.g., Brookings-Wharton Conference on Financial Services, January 2002). These studies conclude that trading will become increasingly concentrated among a small number of exchanges. Furthermore, evidence in support of the trend in the migration of listings from emerging markets to the largest industrialized markets shows a sort of paradox of financial development in which the more

[10] *Various groups have been responsible for the drafting of these standards and codes. US supervisory agencies have contributed to those drafted by the international organizations of supervisory bodies.*

successful a country is in strengthening its financial infrastructure, the more likely are its firms to list on larger, more liquid foreign markets[11]. The trend appears to be away from small, domestic securities markets. If these markets are to survive in some form, many will have to merge into broader coalitions of regional rather than national or local exchanges.

Second, trading systems are moving toward electronic platforms, which reduces the relevance of where an exchange may be physically located. In many markets the physical location of an exchange is simply a function of one or more of the following: domestic regulatory constraints, telecommunications infrastructure, sophistication of investors, tradition, and market appetite. This has direct implications for future donor support for exchange development and policies on harmonization of standards.

Recent Responses to Consolidation of Financial Intermediaries and Convergence of Financial Products

The ongoing consolidation of financial institutions is an important feature of modern financial systems. Mergers among and between banks, non-bank intermediaries, and non-financial enterprises have led to the emergence of large, complex institutions that operate across borders and across traditional product/service lines. While a majority of the consolidation that has taken place in recent years has been in the banking industry, the level of activity among insurance and other non-bank intermediaries has increased. The consequence of this is twofold. First, ironically, financial institutions are becoming both larger and smaller. While some institutions are transforming themselves into universal providers of diversified financial services, others are choosing (or are forced) to specialize in a small range of functions or products as the traditional wholesale/retail supply chain is deconstructed through outsourcing and divestment[12]. Second, in so far as regulations will allow it, there is a high level of convergence in financial products. This had led to overlaps among institutions in the provision of services in banking, insurance, securities trading and underwriting and investment management, as well as across national boundaries through the creation of global networks.

The long-term effect of consolidation and convergence on the performance and efficiency of financial intermediation has not been studied in depth at the global level. However, banks are likely to face increasing pressure from non-bank

[11] *Claessens, Stijn, Daniela Klingebiel, Sergio L. Schmukler, "The Future of Stock Exchanges in Emerging Markets: Evolution and Prospects," Center for Financial Institutions Working Paper No. 02-03, February, 2002, Wharton School Center for Financial Institutions, University of Pennsylvania.*

[12] *An example of this can be gleaned from a review of the roles various participants play in the financial services industry. There are at least five distinct roles around which separate niche industries have emerged: back office services, financial product providers, financial inter-*

providers of payments services, both from other financial institutions and from outside the financial system. Funds managers are gravitating towards the banking market and associations have been formed between banks and non-financial companies[13]. Technological developments seem likely to open the market to other players[14].

USAID assistance programs inevitably do not take place in a vacuum, and must work alongside and support other initiatives that might already be underway in client countries. Some key reform trends stemming from the developments described above include:

De-Regulation: The US passed the Financial Services Modernization Act (FMA) in 1999. FMA repealed the Glass-Steagall legislation from the 1930s, which mandated separation of the securities, insurance and banking industries. Similarly, convergence is also prompting many developing countries to enact or propose new laws allowing intermediaries to provide a broader range of financial services.

Reform of Regulatory Structures: There are important regulatory implications of the developments noted above. The first is that the world is moving into an era of unprecedented complexity with regard to how financial service providers can and should be regulated. This complexity stems from the bundling together of risks that were previously isolated in separate legal entities, the emergence of new types of risk that regulators have not traditionally dealt with, and the increasing need to understand how risk is being managed on a global basis. It has placed an enormous strain on systems with multiple and overlapping regulatory structures.

It stands to reason therefore that one of the most important issues facing policymakers is identifying the appropriate form of regulation for different classes of institutions and where regulatory responsibility should reside[15]. Regulatory efficiency is a significant factor in the overall performance of the economy. Inefficiency ultimately imposes costs that can hinder market functioning and development, or create distortions that divert financial resources from their most productive uses.

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[13] *In the USA, companies like General Electric Corporation have already developed to become major providers of payments services.*

[14] *Technology companies like Microsoft already participate indirectly in the industry by servicing banks' needs.*

[5] *A new global study group has been composed of various senior regulators and market practitioners from the banking, securities, and insurance industries worldwide. The group is examining the evolving linkages and interactions between institutions and markets in an increasingly global financial marketplace and how they are being addressed by banking, securities, and insurance regulators. The aim is to identify the appropriate direction of evolution in supervision for evolving systemic safety of the global financial system in the medium term.*

In response to these developments, regulators in many countries have sought to change the way they supervise institutions. For example, Canada created a single federal banking regulator to improve bank supervision after a series of bank failures, and then moved to integrate regulation of banks and insurance companies. France revised its bank oversight structure to address perceived regulatory inequities among financial institutions. Germany replaced its system of state bank oversight with a federal system, involving both a single federal bank regulator and the German central bank, to better address the increasing complexity of the banking industry. Bank oversight in the U.K. became more formal in nature and driven by a comprehensive risk assessment framework that allocates regulatory resources to the greatest threats. The U.S. has introduced a series of reforms with the introduction of risk-based, consolidated supervision, and new capital standards, among other initiatives. Some developing countries, such as Indonesia, are now considering similar changes. Among the most significant regulatory changes underway are the following:

- **Integrated Regulation:** In a number of other countries regulatory reforms are being designed around new oversight structures that unify regulation between banks and non-banks. The solution that has been introduced to differing degrees by countries as diverse as the United Kingdom, Denmark, Australia, Norway, South Korea, Singapore, Jamaica, Mauritius and others is to adopt a unified regulatory approach for financial institutions and supervise them under a single integrated institution. The broad goals in doing this are to: achieve neutrality in regulation among financial institutions; scale the intensity of supervision by the degree of market failure each institution represents; improve the coordination of regulation towards different objectives - i.e. for safety and soundness, market conduct, and consumer protection; sharpen oversight towards financial conglomerates; and achieve economies of scale by organizing functions to minimize overlap, duplication and conflicts in regulation.

- **Special Regulation For Conglomerates:** As financial conglomerates have played increasingly significant roles in the financial service sectors of developed economies, financial regulators have become more concerned with proper capital and regulatory approaches to these entities. There is also a perception that these institutions present new forms of risk that existing forms of prudential regulation are not suited to handle. Closely intertwined Financial Industrial Groups (FIGs) have caused problems in Japan, Korea, Russia, and other countries as intermediaries seek risk dispersion through the creation of broader corporate structures.

  Consolidated regulation of financial conglomerates requires a comprehensive review of an institution and its affiliated companies. It has created a broader context for inspections in recent years[16]. Forging a regulatory strategy to deal effectively with financial conglomerates requires greater integration among domestic regulators. It also requires harmonization in the approaches traditionally utilized by bank, securities and insurance regulators, whose objectives and methods may vary. New methodologies are being developed to address a wide range of issues such as: impairment of capital for inter-group exposures and/or holdings in other supervised entities; calculation of capital requirements to cover market risks on a group wide basis; group wide application of limits on large exposures in the banking book and the capital requirements against large exposures in the trading book; inter-group transactions; the adequacy of internal control on a group wide basis (especially control over the information which will be relied upon for the application of consolidated supervision); and access to information and power of inspection in all areas of prudential supervision, applicable to both supervised and unsupervised group members; assessment of distribution of capital between group members within a group.

- **Cross-Border Cooperation Among Regulators:** Overseas expansion, increasing globalization of financial markets, and wider use of technology that enables financial intermediation without physical presence have combined to create a need to pursue cross-border cooperation in the supervision of financial intermediaries. In the last few years, home country regulators have heightened their efforts to develop partnerships with foreign regulators. These partnerships take the form of cooperation agreements for the sharing of information, collaboration in the examination of international conglomerates, harmonization of policies, cross-training, and sharing of technical assistance. The trend in developed countries is well advanced of that in developing countries.
- **Domestic Cooperation Among Regulators:** Financial regulation is strongly influenced by national policy, notably monetary policy and public policy. It is also influenced by the mandates of other domestic regulators, which alone may or may not be fully compatible with each other in the overall scheme of financial sector development. Differences exist due to legitimate divergences in objectives and regulatory methodologies. Bank regulators, for example, are most concerned with prudential control and financial system stability, and thus tend to take a more narrow view of what constitutes capital than non-bank regulators. In contrast, securities regulators are concerned with ensuring market integrity and efficiency. They are concerned with

[16] *In the EU consolidated supervision is seen as indispensable to effective supervision of banking and investment services activities. Not only does consolidated supervision form part of the European Union's supervision standards, it is also emphasized in the Basle Core Principles for Effective Banking Supervision.*

information disclosure, liquidity, investor protection and market conduct. To counter these differences, domestic financial services regulators are seeking greater cooperation and coordination with each other. This trend is evidenced by the increasing use of MOUs and policy level interaction between bank and non-bank regulators.

- **Risk-Based Supervision:** In recent years supervisors in many countries have been changing their procedures for supervision to become more risk focused. By employing risk-based reviews, an assessment can then be made of the likelihood that financial institutions are managing and will continue to manage such risks effectively in the future. For most regulators, a risk-focused approach is a shift in emphasis away from assessing past results and transaction testing towards assessing exposure to events in the future and likely performance trends. Risk based supervision also helps regulators better allocate their resources, since the focus is placed on promoting safety and soundness. The approach emerged from a goal shared by banks and their regulators to find a more efficient way to interact between each other. Banks with a strong understanding of risk and driven by the desire to mitigate loss have an inherent incentive to be "better" at managing risks than regulators are in evaluating them.

  Contrasting approaches to risk-based supervision demonstrate that supervisors in different countries can and should fine tune the concept of risk based supervision to reflect the particular nature and size of the institutions they supervise and the markets in which they operate. This is particularly promising for developing countries. The more standardized processes of the OCC's Supervision by Risk reflect the large number of banks subject to OCC supervision, while in other countries the number of locally incorporated regulated banks is much smaller and requires a different approach. Risk assessment procedures in the U.S. and the U.K. take into account differences among institutions, such as complexity or size (e.g. large banking groups versus non complex banks). Other countries have also emphasized strong reliance on internal risk management processes and reports throughout the supervisory cycle.

- **Integrated Approaches to Risk Management:** Following a number of high profile losses in recent years, the need for comprehensive risk management policies and procedures has become more important. Traditional controls are being swept away as organizations change. New technologies are introducing new risks. Business transactions and practices are increasing in complexity, and fraud continues to be a problem. Risk-management systems in complex institutions are being built to continually monitor all relevant risks--including credit, market, liquidity, operational, reputation, and off-balance sheet. Current thinking on risk control embraces the idea that risk management must be an ongoing and organization-wide endeavor. Rather than treat risk management as a series of one-off activities, it should be converted to an integrated process of checks, warning signs, and balances. Such a model must be flexible enough to address both uncontrollable and controllable risks.

The new Basle requirements governing capital adequacy of banks reinforces the trend towards integrated risk management. While the new guidelines are still under global consultation and have faced considerable debate, they are based on the assumption that bank failures stem not from more than just credit or market risk, but from operational, strategic and other risks as well.

- **EU Accession in Post Socialist Europe:** The European Commission launched its Financial Services Action Plan in November 1999, which sets out an ambitious work program to ensure the review of existing Directives and the implementation of new legislation to ensure the completion of the single market by 2005. The areas for action fall mainly into three categories of relevance to financial services: 1) establishing a single EU wholesale market; 2) creating open and secure retail markets; and 3) updating prudential rules and supervision.

  In 1993 a council of the EC adopted a principle of enlargement for many countries of post socialist Europe, and established a series of accession partnerships to advance preparations for eventual integration into the common market. These accession partnerships are broad-based programs that include routine assessment, technical assistance, and policy dialogue between target countries on a range of sector strengthening initiatives, including the development of capital adequacy standards, building governance capacity, and compliance with prudential standards in line with Basle/EU standards. While these developments are not global, they are important to a large number of donor countries, particularly those served by USAID. Efforts by countries to prepare for EU accession underlie major reform trends[17].

The trends toward globalization, consolidation and convergence in financial markets and intermediaries has prompted a series of responses on the part of national regulators and international organizations alike, some of which were described above. While, as mentioned, globalization and convergence appear to bring net-positive benefits to the world economy, they also give rise to important new challenges. Not least of these is the need to ensure that investors, regulators and other interested parties have access to timely, accurate and meaningful information and the need for transparent and responsible governance of increasingly-complex financial institutions. Recent efforts to meet these needs are the topic of the next section.

[17] *USAID's Partners for Financial Stability program recognizes the importance of EU Accession in its objectives.*

II.B.3 Information Disclosure and Governance

From the fall of Barings through the Asian crisis to the more recent corporate fiascos in the United States, participants in financial markets have become acutely aware of the risks of a lack of transparency. Cases of misleading reporting have ranged from understated government deficits to overstated foreign exchange reserves, and from understated corporate debt to overstated corporate earnings. All of these forms of deception can result in gross misallocations of economic resources and can ultimately undermine the credibility of capital markets. When transparency fails in the financial system and when supervisory authorities are weak, the risk of systemic collapse increases substantially.

Attention is now focused on building fair and transparent markets based on principles of market integrity, good information, and investor protection. Efforts to reduce information asymmetry and improve the efficiency of resource allocation in financial markets and among intermediaries cut across five major areas of reform: 1) improvements in the quality of information; 2) stronger corporate governance; 3) establishment and enforcement of disclosure standards; and 4) increased reliance on market discipline.

Improving the Quality of Information

Recent developments in the United States indicate that accounting standards have failed to keep up with the changing business landscape. Innovation in business practices and financial instruments has made accounting standards in some areas rapidly obsolete. For example, the use of derivatives, the valuing of intellectual property, brand equity and other intangible assets all present difficult accounting issues and create potential loopholes for firms willing to use an aggressive approach to accounting. In emerging markets, accounting abuses are common; corporate accounts are not easily available and those that are issued often cannot be trusted.

Reforms aimed at improving the quality of information available to stakeholders of public companies and financial institutions center on six principles of application: comprehensiveness, relevance, timeliness, reliability, comparability, and materiality. Improving accounting and auditing standards, release of timely and accurate information, professional training and integrity in the accounting profession and corporate management is now seen as one of the hallmarks of any financial reform program in both the developed and developing countries. There are widespread efforts underway to strengthen standards at both national and international levels:

- **Moving Toward Global Accounting Standards:** In a recent interview with The Financial Times (26 May 2002), Bob Herz, the incoming chairman of the US Financial Accounting Standards Board (FASB), made it plain that he wants to bring US accounting standards, which are heavily dependent on a rule-based approach, closer to the principles-based approach of International Accounting Standards (IAS) favored in much of the world. This has been called a "revolution", directly attributable to the lessons learned from Enron and other accounting scandals. It will likely hasten the move towards IAS. More and more developing countries have announced a desire to adopt IAS but this involves a good deal of effort in adopting standards, making necessary changes to regulations and providing training to accountants in both the public and private sectors.

- **Strengthening of the Accounting Profession:** Efforts to improve accounting and auditing practices have been complicated by a lack of professionalism both in the subject companies themselves and within the accounting profession. Many developing countries are focusing on revising accounting curricula in their university systems, strengthening professional certification and continuing education and enforcing ethical standards. The World Bank's ROSC process on Accounting and Auditing has provided useful analyses of the state of the accounting profession in various countries and the areas most in need of improvement. USAID has a logical role to play in improving accounting education, certification and continuing education. Assistance in this area could involve the reform of university programs, certification tests and procedures and continuing education arrangements.

- **Auditor Independence and Oversight:** Many new proposals are being considered to improve auditor independence and oversight. These include rotation of audit firms (or at a minimum audit teams), independent commissioners to oversee auditors and restrictions on auditors performing consulting services for their audit clients. In addition, the traditional peer review process followed in many countries is coming into question as proposals are put forward to further strengthen the regulation of the audit profession. In the post-Enron debate, many have posited that a decline in independence and ethics of the American accounting profession is to blame. But this is not a problem limited to the US; most developing countries face greater challenges in this arena. All international professional bodies stress the importance of providing practical education on professional ethics and mechanisms for Institutes of CPAs or CAs to enforce ethical standards. Yet, in many developing countries, ethics is not part of the core curriculum in accounting programs and self-regulation within the profession is very weak. Although the vast majority of accountants are ethical, the lack of enforcement allows the unethical to act without fear of punishment or liability. There is also a trend toward development and strengthening of SROs, such as Institutes of CPAs, to promote improvement of ethics and standards in financial disclosure.

Strengthening Corporate Governance

The ominous tone of much of the treatment of corporate governance issues by investors, international institutions, commercial leaders, academia, and policy-makers underscores the relevance of the topic to economic development. There have been a plethora of official reports on the subject. These have included the American Law Institute report (1992), the Cadbury (1992), Greenbury (1995) and Hampel (1998) reports from the UK, the Hilmer report (1993) in Australia, the Vié not report (1995) in France, the King report (1995) from South Africa, the OECD report in 1998, as well as studies in Hong Kong, Singapore, Malaysia, and elsewhere.

In response to several spectacular company collapses in the UK, the Cadbury Committee reported on the financial aspects of corporate governance - this report led to similar initiatives in other countries. Essentially, Cadbury called for a strengthening of the board's conformance and compliance role. The report advocated the strengthening of the role of independent non-executive directors, the creation of compliance committees using these independent directors in audit committees (to liaise with the company's outside auditors), remuneration committees (to oversee directors' remuneration) and nomination committees (concerned with the nomination of new directors). The strengthening of checks and balances over executive management also recommended more transparency of board matters and the separation of the roles of the chairman of the board from the chief executive officer of the business. Subsequently, the UK Hampel Committee in 1998 consolidated these ideas into a set of Principles of Good Governance and a code of best practice for unitary boards in listed companies to be incorporated into the listing rules of the London Stock Exchange. Many of the official reports provide a code of best practice in corporate governance, detailing expectations on matters such as board structure, audit and audit committees, transparency in financial accounting and director accountability. Some institutional investors, particularly in the United States, have also called for codes of corporate governance practice. Increasingly, to obtain access to international equity finance, companies around the world have to respond to the corporate governance requirements of these codes.

Corporate governance has been slow to improve in many developing countries because their policy and institutional environments are less conducive. There are many commonalities among countries with weak governance structures: regulations are weakly enforced; shareholders are not aware of their rights or loath to intervene; mechanisms to intervene are weak, governance systems are not robust or incentive incompatible; economic wealth and influence is concentrated; there is little or no external pressure from market forces, ownership rights are uneven; information asymmetries eliminate the possibility of effective external monitoring, and there is a weak culture of respect for shareholder democracy. Time and again, cross-country comparisons around the globe identify these factors.

The application of corporate governance reform in transitional countries has many dimensions. Many of these cannot be adequately addressed given the scope limitations of this paper. However, some important areas of reform are noted below.

- **Tailored Development of Corporate Governance Frameworks:** In April 1998 the Business Sector Advisory Group on Corporate Governance issued its report "Corporate Governance -improving competitiveness and access to capital in global markets". The Committee was comprised of distinguished experts from the US (chair), France, Germany, Japan and the UK. Their report proposed that the OECD recommend minimum standards of corporate governance to promote fairness, transparency, accountability and responsibility. However, it rejected a "one-size-fits-all" approach to corporate governance, advocating pluralism and adaptability. In addition, it is more and more accepted that the corporate objectives of maximizing shareholder value requires not only superior competitive performance and transparency, but also responsiveness to the demands and expectations of employees, local constituencies, and other stakeholders. Corporate governance systems are being developed to reflect the specific features of unique markets.
- **Common Features of Corporate Governance Reform:** Of the governance reforms that are being implemented around the world, there are common features that appear time and again. These include: adaptation of corporate governance regulatory frameworks to changing competitive and market forces; formulation of minimum standards of corporate governance designed to promote fairness, transparency, accountability and responsibility; issuing suggested guidelines for voluntary "best practices" for boards to improve accountability, as well as to promote board independence; establishment of common principles for addressing comparability, reliability and enforcement of corporate disclosure; and emphasis on the impact which changes in corporate governance practices would have on society at large, and on the need to clarify responsibilities between the public and the private sector.
- **Shareholder Activism:** In the past, when capital markets played a smaller role in financial intermediation, shareholders were relatively few and close enough to the board of directors to exercise a degree of control. Most institutional investors ignored their rights as shareholders, preferring to sell their shares rather than get involved in challenging corporate performance. But for major corporations, particularly those, which have their shares listed on

a stock exchange, the governance situation has changed[18]. In many countries, shares of public companies are now held by a diverse body of shareholders: some by private individuals, some by institutional investors such as banks, pension funds and insurance companies, and some by other companies, who might have business relationships with the company. The growing complexity of corporate structures has led to trend towards greater shareholder activism, particularly in the United States, Great Britain and Australia. Shareholders are becoming pro-active, calling for boards to produce better corporate performance, questioning directors' remuneration, and calling for greater transparency on company finances and more accountability from directors.

- **Strengthening Governance of the Financial Sector:** In April 2002, the World Bank conducted a seminar on Financial Sector Governance to examine the governance of regulators, self-regulatory organizations (SROs), accountants, analysts, and that of banks, fund managers and securities firms. This seminar highlighted the weak links in the financial system and the assistance needed to improve conditions in emerging markets. Recognizing this, many donors, international financial institutions, and domestic governments have provided generous financial and intellectual support for the development of an enabling environment for corporate governance of financial institutions. This support has included the development of market institutions, legislation and regulations, standards, and educational programs.
- **Public Sector Governance in the Financial Sector:** The public sector plays a dominant role in financial markets, either as an owner of intermediaries and markets and/or as their regulator. Governments regulate, as well as own, banks and other financial institutions, issue debt, intervene in currency markets, and play an important role in pension systems, all closely linked to financial markets. With such a dominant role, a sound financial market depends on public sector transparency, accountability, and fairness and the absence of corruption or conflict of interest. Recent experience has shown that new institutions, rules and procedures can become as corrupt as the practices and institutions they replace. For this reason, donors continue to assist in rationalizing the states' role in the financial markets, accompanied by measures geared towards building a culture of good public sector governance.

[18] *Experience in U.S. is an exaggeration of the dramatic change in the institutional ownership composition of public companies globally, but it is indicative of the trend. According to the flow of funds accounts published by the Federal Reserve, the combined share of household equity managed by mutual funds, pension funds, and life insurance companies grew from only 3 percent in 1952 to over 50 percent at the end of 2001. Mutual funds held 16 percent of household equity at the end of last year, and public and private pension funds held about 10 and 20 percent, respectively. Life insurance companies held about 7 percent of household equity at that time, mainly through separate accounts that were, in effect, mutual funds with insurance wrappers.*

Establishing and Enforcing Disclosure Standards

Disclosure standards for both banks and non-banks are being strengthened to reflect the growing complexity of financial services and concerns regarding poor corporate governance. They are an essential component of market conduct and prudential regulation across the financial sector and are necessary in order to provide participants with the information necessary to evaluate performance and make informed investment decisions.

New disclosure standards are being set forth for a range of activities including: cross-border offerings of securities, derivatives transactions, group transactions, related party transactions, loan concentrations across geographic and client lines, cross-border investments, foreign exchange activities, reporting across multi-jurisdictions and numerous other areas.

Standards mean little without continuous monitoring and enforcement. This is a particular problem in developing countries where securities regulatory commissions typically lack the systems, staffing and capability to adequately monitor financial reporting by companies and often lack the will and "teeth" to enforce these rules. Donors can play a role in assisting developing countries to improve accounting and disclosure related law and regulation, clarify the organizational roles and responsibilities of governmental and industry oversight agencies and professional bodies and provide capacity building assistance to these organizations.

Reliance on Market Discipline As a Regulator

Regulators play an important role in preserving financial stability and credibility of markets. But the increasing complexity of the financial sector present challenges to even the most skilled of regulators in identifying where risk is latent. The liberalization of markets by de-regulation has intensified the challenge.

Policymakers are recognizing that a balance between prudential supervision and market discipline is critical to promoting long-term stability of both individual institutions and banking systems[19]. There is a growing realization that market discipline, when facilitated by strong disclosure practices, is a powerful regulator of both risk and efficiency in capital allocation. Market discipline approaches to market development seek to maximize the scope for competition and innovation and help to mitigate moral hazard. The aim of this type of regulation is to make markets themselves work better, rather than substituting the decisions of government with those of the market. Market discipline is

[19] *European markets tend to emphasize self-regulation and to rely on market forces to produce incentives to disclose important information. This trend is especially characteristic of the Eurodollar market and has been perceived by participants in that market as highly successful.*

enhanced by better public disclosure. Public disclosure of risk indicators puts pressure on financial institutions to improve their risk management practices and policies, reinforces the accountability of senior management and is less intrusive or restrictive that other measures such as entity licensing, price fixing, product vetting or investment targeting.

Two ways in which regulators are seeking to achieve balance between formal regulation and market discipline are by: 1) enhancing comparability of analysis among intermediaries through stylization, standard reporting classifications and data definitions; and 2) by promoting mechanisms designed to ensure compliance with disclosure standards and the strengthening of standards that ensure reliability of information.

As part of the effort to strengthen market discipline, there are important trends related to the development and use of SROs in the regulation of certain institutions and markets. International guidelines on financial sector regulation recommend the use of SROs to the extent appropriate to the size and complexity of the markets. In the face of scarce resources, regulators have mostly supported the development of SROs for stock exchanges, the stock brokerage industry, clearing, depository, and settlement institutions, specialized institutions, such as credit cooperatives and microfinance institutions.

Self-regulation has demonstrated substantial benefits. For instance, self-regulation should promote the reputation of the relevant industry as a whole, and it might facilitate the creation of technical standards that will benefit the industry itself more generally. In addition, self-regulation may be better than a pure government solution. The same factors that can make self-regulation better than the market may also make it better than government. Self-regulation may also be adopted in order to stave off mandatory government regulation, and may thereby gain some of the good attributes of both government regulation and industry participation.

Legal Reform

Greater support for supervisors and enforcement efforts has more recently been accompanied by support for legal reform. Increasing the capacity of administrative courts, development of alternative dispute resolution mechanisms, and/or development of judicial review standards should all be considered as critical to improving the regulatory and supervisory system overall.

II.B.4 E-Finance

New payments mechanisms like ATMs, telephone banking, EFTPOS, and electronic funds transfer can increase access to bank account services. Internet platforms have enabled the establishment of new distribution channels in the form of 'virtual banks', which can transact as a traditional deposit-taking institution as well as offer securities[20]. In a similar vein, consumers are able to use electronic media to search for financial products that best meet their desired specifications. The application of information technology in this manner should help reduce the information difference between financial institutions and individuals.

While electronic finance is spreading quickly, there is considerable dispersion among countries in the degree of penetration of e-finance. That dispersion is expected to continue over the next five to ten years, and then will begin to narrow. The World Bank estimates that 50 percent of banking will be on-line in industrial countries by 2005, up from 9 percent in 2000. In developing countries the estimate is 10 percent in emerging countries by 2005, compared to only one percent in 2000. Those living in emerging countries under a rapid evolution of telecommunications are likely to find viable opportunity by adopting the new technologies. Brazil, the Czech Republic, Estonia, India, Mexico and the Republic of Korea already have substantial penetration in either e-banking or e-trading.

The full impact of these developments, both their benefits and their risks, remains largely unknown. But it is becoming clear that the potential growth of e-banking and the elusive nature of the activity could have a revolutionary impact on the financial services industry and its supervision, as it is known today. Governments and donors must seriously consider how the coming of e-finance will affect the development of financial systems and distribution of financial services in emerging markets.

The following key topics are of an emerging nature, and were selected based on recent industry trends, as well as their expected relevance to regulators, and thus donors.

International Cooperation: There is a real concern that international cooperation is necessary for effective supervision of e-finance, and that premature domestic regulation may not be enough to address the issues that emerge. In November 1997, the OECD held an international conference in Finland on the subject of "Dismantling the Barriers to Global Electronic Commerce." While finance and insurance as topics were only in passing many of the more general conclusions reached applied to these sectors. Emphasis was placed on reducing regulatory uncertainty in the new electronic environment, balanced by minimal government intervention, which should be specific, precise, and transparent. The concept of "branding" or accreditation was introduced as mechanisms for legitimizing providers of services. International cooperation in the formulation of rules was urged, as was the need for uniformity of rules across jurisdictions.

[20] *Prospectuses have already been authorized for release on the internet in the U.S.*

Regulation of E-Finance: Most governments are continuing to rely on existing laws and regulations rather than enacting comprehensive new measures for the regulation of the area. However, internal policy discussions have begun in many countries around several important issues, such as the following:

- How should public policies be fashioned to facilitate the growth of e-finance, while also safeguarding financial stability and the protection of consumers of financial services?
- Under what jurisdictions of e-finance activities fall and are existing regulations adequate to meet the public policy objectives?
- What are assurances, if any, extended to the public vis-a-vis deposit insurance and other protection mechanisms?
- How does e-finance affect lender of last resort policies?
- What are the risks to the payments systems?
- How far should regulations extend in respect of electronic security and privacy?

Developing International Standards: In terms of prudential regulation for e-finance, most developed countries have in the past followed a hands-off approach. But this seems no longer adequate. The prudential measures that need be taken are presently under review in international forums, such as the Electronic Banking Group of the Basle Committee on Banking Supervision. (See box above on standard-setting bodies.) Once standards of best practice are developed, governments of developing countries will have to consider how best to apply them in their particular situation. Development of e-finance will also depend upon the development and regulation of the telecommunications industry.

Increasing Financial Sector Competition through E-finance: The benefits of e-finance will be largely driven by the competition created by new entrants to the markets. But not all market participants welcome greater competition, raising the issue of competition policy. Governments will have to balance the advantages of competition to users of financial services with the costs to existing providers, which are often government owned. This issue is heightened by globalization and competition from foreign providers. Here competition can be stymied or at least slowed by differences in laws, such as bank secrecy acts or money laundering rules. Furthermore, the introduction of e-finance will not in itself assure competition. Complex conglomerates may well develop from liaisons of telecom providers and financial institutions able to control content and limit access to networks by competing service providers. International coordination of competition policy will probably be necessary to maintain adequate Internet service provider access.

Expanding Access to Financial Services through E-finance[21]: The rationale supporting direct government intervention in financial markets is based on arguments around market imperfections and market failure. Providing poor individuals and small firms with financial services has in many countries been prohibitively expensive. To make serving these groups sustainable, new technologies are needed. E-finance may fulfill this role. Lower operating costs makes it possible to provide financial services more widely and better information makes markets more complete. Smart cards are now in use for payment services in 16 African countries. Mortgage and insurance services are increasingly being offered on-line in developing countries. Internet services are expanding finance for SME and a small number of financial intermediaries are beginning to offer microfinance services to quite poor people. E-finance will not enable everyone to access financial services but will make it possible to expand the availability of services to new classes of customers. Instead of direct intervention to assist the poor and small business obtain adequate financial services, which has not worked well, governments should in the future concentrate on building the enabling environments required for the private provision of financial services to these groups, though some incentives may be necessary to speed action.

Donors' Considerations for Introduction of E-Finance

- E-finance will have a major impact on financial institutions and on the manner in which finance is conducted, particularly in developing countries.
- E-finance will almost certainly increase competition from existing firms adopting cheaper on-line technologies, from new firms able to enter the industry because of the falling cost of entry and reduced economies of scale and from foreign providers of financial services over the Internet.
- Greater competition and lower production costs will reduce the price of financial services, the spreads of intermediaries, the revenues of established firms and probably their profits. This will adversely affect banks and other intermediaries with weak portfolios, excessive operating costs and precarious financial conditions, many of which are government owned.
- E-finance provides more than new delivery channels. It will enable providers to personalize service and to use enhanced information to price risks better. This will be particularly true in retail finance.
- Purely on-line banks have not been very successful, but competition is forcing existing intermediaries to offer on-line services. Other types of firms, such as telecommunication companies and Internet providers are entering the financial field, sometimes on their own, but more frequently in partnership with financial firms. New types of firms are being established, such as those that allow customers to compare on-line mortgage rates or insurance costs.

As shown in the text box above, many donors are now considering the potential role of e-finance in improving the depth of competition, transparency, and access by the poor and by small businesses to financial services. There is a genuine need to understand the implications of e-finance for the emerging markets and support governments in building an infrastructure in which e-finance can flourish.

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[21] *The EGAT Bureau is using a new development tool, the Global Development Alliance (GDA). Alliance partners make financial and/or in-kind contributions to increase the impact and sustainability of development efforts. Due to the need for specialized skills and a significant investment in technology that may be required for the introduction of e-finance, USAID might consider using the GDA structure for piloting e-finance projects in selected countries.*